

NONPROFIT GOVERNANCE: WHO SHOULD BE WATCHING?

A LOOK AT STATE, FEDERAL AND DUAL REGULATION

JACLYN FABEAN CHERRY*

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I. INTRODUCTION

Recent scandals in the nonprofit sector have once again called into question the issue of nonprofit governance. Who is governing these organizations and are they doing so appropriately? Who is regulating

* Associate Professor of Law, University of South Carolina School of Law. The author would like to thank Emily Godwin, Esq. for her impeccable research and work ethic and Vanessa McQuinn for her administrative support.

and what law applies—federal, state, or both? The one thing that is certain is that clarity is needed.¹ True to form, the egregious behavior of some of those serving on the boards of directors of large organizations has brought these issues back into the spotlight, raising questions for regulators and the general public about the validity of these and other organizations and the truth of their stated missions. While most assume that clear laws dictate the behavior of those entrusted with the care of charitable nonprofit organizations, some scholars question just how clear these laws are and whether overstepping by the Internal Revenue Service in this area may be causing confusion.² Others believe that while nonprofit governance

¹ Ed Connors, *Your Nonprofit Board as Reality Show: Trump Foundation Offers a Cautionary Tale*, NONPROFIT Q. (June 21, 2018), <https://nonprofitquarterly.org/2018/06/21/your-nonprofit-board-as-reality-show-trump-foundation-offers-a-cautionary-tale/> [<https://perma.cc/9MLZ-24B8>]; David A. Fahrenthold, *Trump Foundation Admits to Violating Ban on 'Self-Dealing,' New Filing to IRS Shows*, WASH. POST, (Nov. 22, 2016), https://www.washingtonpost.com/politics/trump-foundation-apparently-admits-to-violating-ban-on-self-dealing-new-filing-to-irs-shows/2016/11/22/893f6508-b0a9-11e6-8616-52b15787add0_story.html?utm_term=.1271b7b27a9b [<https://perma.cc/PP6X-V7CX>]; Press Release, N.Y. State Office of the Att’y Gen., Attorney General Underwood Announces Lawsuit Against Donald J. Trump Foundation and Its Board of Directors for Extensive and Persistent Violations of State and Federal Law (June 14, 2018) <https://ag.ny.gov/press-release/attorney-general-underwood-announces-lawsuit-against-donald-j-trump-foundation-and-its> [<https://perma.cc/D5FY-H4D2>]; Andrea Fuller, *Pistachio Billionaires' Foundation Lends Millions to Business Associates*, WALL ST. J., (June 28, 2018) <https://www.wsj.com/articles/nut-company-owners-foundation-lends-millions-to-business-associates-1530178200> [<https://perma.cc/PQ52-ZTUD>]; Henry Cordes & Matthew Hansen, *Goodwill Omaha Executive Pay: An Investigative Series*, OMAHA WORLD-HERALD (Oct. 26–Dec. 3, 2016), <https://dataomaha.com/media/news/2016/goodwill/> [<https://perma.cc/YY46-W7C3>]; Ruth McCambridge, *Nebraska AG: Board Members Convinced Goodwill CEO Was Best in Class Even as Red Flags Waved*, NONPROFIT Q. (June 28, 2018), <https://nonprofitquarterly.org/2018/06/28/nebraska-ag-board-members-convinced-goodwill-ceo-was-best-in-class-even-as-red-flags-waved/> [<https://perma.cc/HP2H-LC4Z>].

² See generally, e.g. S.C. CODE ANN. § 33-31-101 to -1708 (providing nonprofit laws for South Carolina); UTAH CODE ANN. § 16-6a-101 to -1705 (West 2018) (providing nonprofit laws for Utah); MODEL NONPROFIT CORP. ACT (AM. BAR ASS’N 2008) (providing model nonprofit laws as suggested adoption by states); NICHOLAS P. CAFARDI & JACLYN FABEAN CHERRY, TAX EXEMPT ORGANIZATIONS: CASES AND MATERIALS (3d ed. 2014) (giving in-depth discussion of nonprofit statutes and case law and discussing evolving areas of debate and uncertainty); Amy Moore, *Rife with Latent Power: Exploring the Reach of the IRS to Determine Tax-Exempt Status According to Public Policy Rationale in an Era of Judicial*

was once the purview of the states alone, the federal government has inappropriately preempted oversight in this area.³ Charitable nonprofit organizations incorporate under state law and receive tax exemption in accordance with federal law,⁴ resulting in a system that has sometimes complicated legal matters. Yet, under both state and federal law, nonprofits must function to carry out their organizational missions for the good of the public⁵ Recently, the Trump Foundation, the Resnick Foundation, and Goodwill Omaha, all designated as charitable nonprofit organizations by the Internal Revenue Service, have been the focus of scandal and review. Taken together, they represent many of the challenges that are at the core of this governance issue.⁶ A review of the facts in these and other situations will help clarify the issue and help focus on potential resolution.

In Parts I-III, this Article will begin by discussing nonprofit governance, a board of director fiduciary duty, and federal, state, and common law as they pertain to nonprofit governance. It will set out different theories for whether the IRS has, in fact, overstepped its authority in this area by regulating nonprofit governance matters and discuss whether there should be more cooperation between the IRS and states attorneys general. Part IV will summarize three recent situations as examples of this current dilemma.

More specifically, in Part V, this Article will review the claim by many scholars that by regulating nonprofit governance through IRS forms 1023 and 990, the IRS has overstepped its authority; it will also

Deference, 56 S. TEX. L. REV. 117 (2014) (discussing IRS power, judicial review, and general uncertainty in nonprofit law as seen in *Bob Jones University v. United States*); Andrew Pruitt, *Judicial Deference to Retroactive Interpretative Treasury Regulations*, 79 GEO. WASH. L. REV. 1558 (2011) (discussing uncertainty in current IRS regulatory authority, generally).

³ James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545 (2010); Bruce R. Hopkins, *IRS Regulation of Nonprofit Governance: A Critique*, 30 TAX'N EXEMPTS 4 (2018).

⁴ I.R.C. § 501(c)(3) (2018). This source does not state that charitable organizations are incorporated under federal law, but is the federal law which regulates charitable institutions.

⁵ See *id.*; see also CAFARDI & CHERRY, *supra* note 2, at 87.

⁶ Petition, *New York v. Donald J. Trump* (N.Y. Sup. Ct. 2018), https://ag.ny.gov/sites/default/files/court_stamped_petition.pdf [<https://perma.cc/3GW3-XZKF>]; DOUGLAS J. PETERSON, NEB. ATT'Y GEN., NEB. DEP'T JUST., REPORT ON INVESTIGATION OF GOODWILL INDUSTRIES, INC. AND GOODWILL SPECIALTY SERVICES, INC. (2018) [HTTPS://AGO.NEBRASKA.GOV/SITES/AGO.NEBRASKA.GOV/FILES/DOC/2018.06.26%20GOODWILL%20PUBLISHED%20REPORT.PDF](https://ago.nebraska.gov/sites/ago.nebraska.gov/files/doc/2018.06.26%20GOODWILL%20PUBLISHED%20REPORT.PDF) [[HTTPS://PERMA.CC/2MG5-FTWN](https://perma.cc/2MG5-FTWN)]; CORDES & HANSEN, *supra* note 1; FULLER, *supra* note 1.

explore the theory that the IRS has gone even farther by regulating through the private benefit doctrine.⁷ It will ask if the IRS has overstepped and, if it has, whether it has done so out of necessity because state attorneys general are overworked, understaffed, and generally unable to keep up in this area. It will also ask whether, as one scholar advocates, dual oversight is not only legal but actually more effective.⁸ Further, in Part VI, this Article will compare similarities between nonprofit and for-profit governance regulation to glean any useful lessons, and in Part VII, it will explore policy considerations surrounding these governance issues. Finally, in Part VIII, it will suggest that perhaps dual jurisdiction with established roles and mandatory information sharing may work best given the many nuances in the sector and the political nature of the offices tasked with this oversight.

II. DUAL REGULATION

In recent years, as the Internal Revenue Service (IRS) has increased its monitoring of charitable nonprofits in the governance realm, questions have arisen as to what, if any, authority the IRS has in this area. While the function of the IRS is generally to ensure that taxpayers pay their taxes, the agency holds a slightly different role regarding charitable nonprofit organizations. The IRS regulates charitable nonprofits under its Tax Exempt and Government Entities Division (TE/GE).⁹ The mission of TE/GE is “to provide our customers top quality service by helping [them] understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.”¹⁰ The Division determines whether an organization will be granted tax exempt status, issues and reviews annual information returns (IRS Form 990), and revenue rulings and procedures.¹¹ Its role is to ensure that there is

⁷ See, e.g., *Free Fertility Found. v. Comm’r*, 135 T.C. 21, 25–26 (2010) (applying private benefit doctrine).

⁸ Lloyd Hitoshi Mayer, *Fragmented Oversight of Nonprofits in the United States: Does it Work? Can it Work?*, 91 CHI.-KENT L. REV. 937 (2016).

⁹ See I. R. S., *Tax Exempt & Government Entities Division At-a-Glance*, (last updated June 1, 2018), <https://www.irs.gov/government-entities/tax-exempt-government-entities-division-at-a-glance> [<https://perma.cc/2UHY-5ED9>]. This source doesn’t include all the information attributed to it. I think the author may have been trying to cite to this article <https://www.irs.gov/charities-non-profits>. However, it’s not clear this source contains everything the author is attributing to it.

¹⁰ *Id.*

¹¹ *Id.*

compliance with the tax laws necessitating, in this instance, some involvement in nonprofit governance. While the agency may have been initially charged with a more limited role, reports commissioned by Congress and revisions in the Internal Revenue Code led to an increase in the role the IRS plays in charitable nonprofit regulation.¹² As other committees were commissioned¹³ with the goal of improving voluntary compliance, and reporting forms were revised in 1961 and again in 1969 as a result of The Tax Reform Act of 1969, it was determined that the IRS remain the “principal regulating agency for tax exempt organizations”.¹⁴ In 1996, Congress enacted tax laws that provided for the imposition of excise taxes on public charities, opening the IRS into the realm of fiduciary duties. And in 1998, when Congress overhauled the IRS, the role of the agency changed from one with a focus on tax collection to one that would maintain “the integrity of the tax exempt sector.”¹⁵ As a result, an organization receiving tax-exempt status by this division of the IRS must continue to meet the standards under which it was granted exempt status. At the same time, it must abide by the law of the state where it was incorporated, and often it must conform to the laws of the other states in which it has offices.¹⁶

A. *State Oversight*

Nonprofit corporations are governed by state law. An organization choosing the nonprofit corporate form generally incorporates in the jurisdiction where it is located, although for many other reasons, including taxes and additional sites of operation, it may choose another state.¹⁷ Therefore, the structure of a charitable organization (corporation, trust, unincorporated organization) “affects the role of

¹² See MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION*, 65–75 (2004) (The Walsh Commission, the Cox Commission and the Reece commission, focusing mostly on Foundation behavior based on a suspicion that this type of charity was being used by the wealthy for power).

¹³ *Id.* at 74.

¹⁴ FREMONT-SMITH, *supra* note 12, at 82.

¹⁵ FREMONT-SMITH, *supra* note 12, at 97.

¹⁶ See S.C. CODE ANN. § 33-31-1501 (2012) (explaining foreign corporation requirements); see also N.C. CODE ANN. § 55A-1-21(2) and § 55A-15-01(a).

¹⁷ Stephanie Dube Dwilson, *How to Choose Where to Incorporate Your Non-Profit*, CHRON (last visited Aug. 28, 2018), <https://smallbusiness.chron.com/choose-incorporate-nonprofit-66602.html> [<https://perma.cc/6R8Q-C9T7>].

the state in [its] affairs.”¹⁸

When an organization is structured as a nonprofit corporation, the attorney general has only the powers specified in the state’s nonprofit corporation statute or other statutes. Normally these statutes involve the attorney general only in the case of egregious or criminal behavior by the organization or its board or, in some instances, during the dissolution process. When the nonprofit organization is structured as a charitable trust, however, the role of the state attorney general is greater because the beneficiaries of a charitable trust are considered to be indefinite and unable to speak for themselves. In those cases, the state attorney general has the common law power, under the doctrine of *parens patriae*, to bring suit to enforce the terms of a charitable trust and to see that charitable trust assets are in fact used for charitable purposes.¹⁹

Typically, the state attorney general is responsible for overseeing charitable organizations in order to protect the public’s interest. He or she is responsible for assuring the proper distribution of charitable trusts and can bring an appropriate action when there is a perceived violation. The attorney general is responsible for the enforcement of charitable solicitation laws and for overseeing mergers and acquisitions between charities. It is only the attorney general who can institute a legal proceeding because the general public lacks standing.²⁰

“[C]hoice of form does make a difference for operational, governance and dissolution purposes.”²¹ States employ widely differing approaches regarding nonprofit corporations.²²

¹⁸ NICHOLAS P. CAFARDI & JACLYN FABIAN CHERRY, UNDERSTANDING NONPROFIT AND TAX EXEMPT ORGANIZATIONS § 2.05 (2d ed. 2012) [hereinafter CAFARDI & CHERRY, UNDERSTANDING]; see also AM. BAR ASS’N, *supra* note 2, §§ 1.51–.53, 3.04, 8.09, 13.09, 14.02; CAL. CORP. CODE §§ 5142, 5250, 6511, 9230 (West 2018); N.Y. NOT-FOR-PROFIT CORP. LAW § 112; 2., 329 P.2d 118, 132–33 (Cal. Dist. Ct. App. 1958), *superseded by statute*, CAL. PROB. CODE § 24 (West 2018), as recognized in *Patton v. Sherwood*, 152 Cal. App. 4th 339, 347 (Cal. Ct. App. 2007).

¹⁹ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18; see also Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 657 (1998); A UNIFORM SUPERVISION OF TRUSTEES FOR CHARITABLE PURPOSES ACT, 7B U.L.A. 727 (1978); ABA, *supra* note 2; CAL. CORP. CODE, *supra* note 18; N.Y. NOT-FOR-PROFIT CORP., *supra* note 18; *Brown*, *supra* note 18, at 132–33.

²⁰ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18; Atkinson, *supra* note 19, at 657.

²¹ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 2.03.

²² Compare MODEL NONPROFIT CORP. ACT (AM. BAR ASS’N 1952), with MODEL NONPROFIT CORP. ACT (AM. BAR ASS’N 1964); see also MARILYN E. PHELAN,

B. Internal Revenue Code

An organization, and therefore its board of directors, has a “duty” to maintain its tax exemption, which means it must meet the tests set forth by Internal Revenue Code (IRC) section 501(c)(3).²³ the organization must be organized and operated in keeping with its charitable mission; it must avoid private inurement; and it cannot partake in political activity (no electioneering, some lobbying).²⁴ The private inurement test states that an organization does not qualify for exemption if the organization’s net earnings inure in whole or in part to the benefit of private shareholders or individuals.²⁵ Private shareholders and individuals are the insiders of an exempt organization, including its board members, officers, and managers.²⁶ Also, if private individuals or groups, having no direct control over the organization, benefit to an inordinate amount, a private benefit exists, which is also a violation of the requirements of IRC section 501(c)(3).²⁷

III. ROLE OF GOVERNING BODY

The governing body of a nonprofit organization, the board of

NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS, AND ASSOCIATIONS (2000) (See individual state statutes for information on their approach to nonprofit corporations).

²³ See *supra* note 4, The statutory language lists the following as exempt from taxation:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

²⁴ See *Id.*

²⁵ See Treas. Reg. § 1.501(c)(3)–1(c)(2), (d)(1)(ii) (1960).

²⁶ *Id.*; see also RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. LAW INST. 2007).

²⁷ See I.R.C., *supra* note 4; Treas. Reg., *supra* note 25.

directors (board), is responsible for overseeing the operation of the organization, ensuring integrity to its mission and effectiveness of its management, a role that is critical to the legal operation of the organization.²⁸ The board oversees the exercise of all the powers of the organization in accordance with applicable state law and by the mandates of the organization's bylaws.²⁹ The board may be self-perpetuating with members serving specific terms throughout the organizations' existence.³⁰ The nonprofit organization is mission-driven; therefore, directors are held to a high standard of care to protect the organization and uphold its mission.³¹ Since these organizations are public charities, it is imperative that their missions to serve the public are upheld.

State laws require that the board of directors individually and collectively act in the name of and commit the highest level of care to the organization.³² Moreover, the board is bound through the fiduciary duties of care, loyalty, and obedience.³³ The board's duty to mission

²⁸ See *Board Roles and Responsibilities*, NAT'L COUNCIL NONPROFITS, (last visited Aug. 28, 2018), <https://www.councilofnonprofits.org/tools-resources/board-roles-and-responsibilities> [<https://perma.cc/F2M6-WBEP>]; Herrington J. Bryce, *Nonprofit Board Responsibilities: The Basics*, NONPROFIT Q. (Aug. 21, 2017), <https://nonprofitquarterly.org/2017/08/21/nonprofit-board-governance-responsibilities-basic-guide/> [<https://perma.cc/L3X7-UVJW>].

²⁹ MODEL NONPROFIT CORP. ACT, *supra* note 2, at § 8.01(b) .

³⁰ MODEL NONPROFIT CORP. ACT, *supra* note 2, at §§ 8.05–.06 (State statutes can permit the founder of a nonprofit corporation to include a provision in the articles of incorporation or the bylaws that requires the founder or another specified person or body to agree to all or certain board decisions); See MODEL NONPROFIT CORP. ACT, *supra* note 2, at § 8.21(a). Specifically, the Model Nonprofit Corporation Act provides the following:

Some, but less than all, of the powers, authority or functions of the board of directors of a nonprofit corporation under this [act] may be vested by the articles of incorporation or bylaws in a designated body To the extent the powers, authority, or functions of the board of directors have been vested in the designated body, the directors are relieved from their duties and liabilities with respect to those powers, authority, and functions.

³¹ See, e.g., MODEL NONPROFIT CORP. ACT, *supra* note 2, at § 8.30; CAL. CORP. CODE, *supra* note 18, at § 5047.5; N.Y. NOT-FOR-PROFIT CORP. LAW, *supra* note 18, at §§ 715-a, 717 (The board's primary responsibility is to oversee the organization to which it owes its fiduciary duties).

³² See, e.g., MODEL NONPROFIT CORP. ACT (AM. BAR ASS'N 2008); E.g., S.C. CODE ANN. §§ 33-31-101-1708.

³³ See *Board Roles and Responsibilities*, *supra* note 28.

(duty of obedience) states that the board must “‘be faithful to the purposes and goals of the organization,’ since ‘[u]nlike [the for-profit corporation], whose ultimate objective is to make money,’” the nonprofit corporation’s objective is to carry out its particular mission.³⁴

The board’s primary responsibility is to oversee the organization to which it owes fiduciary duties. Because the organization’s activities and affairs are under the board’s direction, the board must work to be vigilant in carrying out and documenting all decisions. In a charitable nonprofit organization, the board of directors makes decisions as a single body; individual directors, in the absence of board authorization, have no authority to bind the corporation.³⁵

A board’s relationship to its senior executive varies according to a multitude of factors, such as size of the organization, size of the board, mission of the organization, and customs within the particular “industry.” For example, the board of a very large organization may depend on the senior executive to a greater extent and delegate more authority than would the board of a much smaller organization. It remains the board’s duty to oversee the organization, no matter the external influencing conditions.

In some organizations, a senior paid executive may be a member of the board of directors, though issues involving a conflict of interest (implicating the duty of loyalty) become even greater in such situations. It becomes imperative that the board document all decisions and require the senior paid executive to recuse herself from decisions that could both jeopardize the integrity of the board and the executive

³⁴ *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999) (quoting V. BJORKLUND ET AL., *NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS* §§ 1–3(c) (3d ed. 2007)). James Fishman describes the duty of obedience, in part, as follows:

Beyond obeying the organizational documents, a nonprofit corporation and its directors and officers have the responsibility to comply with the law Note that although directors are responsible for compliance with legal requirements in areas of obvious significance, such as payment of taxes, they are not responsible for technical compliance with every aspect of a regulatory regime.

James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 237–38 (2003); *See also* Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43 (2008).

³⁵ CAFARDI & CHERRY, *UNDERSTANDING*, *supra* note 18, § 3.03.

and violate their fiduciary duties.³⁶

A. *Fiduciary Duties*

The fiduciary duty of the board as a whole and of its members individually finds “its genesis in trust law, *fiducia*, meaning trust.”³⁷ “[T]he relationship between a board and the organization it serves is similar to the relationship between a trustee and the trust’s beneficiary. The fiduciary obligation serves as ‘an alternative to [the] direct monitoring’ [by the states or federal government] of a board’s behavior.”³⁸ The board is responsible for monitoring not just compliance with applicable law but also compliance with board-adopted policies, including those relating to conflicts of interest, travel and entertainment expense reimbursement, whistle-blowing, and document retention, as well as broader codes of ethics.³⁹

³⁶ *Id.* at § 3.03(b)(3).

³⁷ *Id.* at § 3.03; *see also* CAFARDI & CHERRY, *supra* note 2, at 6–7; Fishman, *supra* note 34, at 227–28.

³⁸ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03.

³⁹ *See Id.* §§ 3.01–.02; CAFARDI & CHERRY, *supra* note 2, at 6–7; “[I]n a business corporation, the directors owe their duties to the corporation.” RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 310 cmt. a(1) (AM. LAW INST. 2007). But “in a private (noncharitable) trust, trustees owe fiduciary duties to the beneficiaries In the case of a charitable trust, which lacks ascertainable beneficiaries who can enforce their rights, the fiduciary duties are instead said to run to the charitable purpose” *Id.* Subject to any authority reserved to the [organization’s] membership or other person, the board’s functions normally include, but are not limited to:

- (1) monitoring implementation of the [organization’s] purposes, and modifying those purposes as necessary and appropriate . . . ;
- (2) adopting bylaw provisions that address governance issues, and amending the bylaws as necessary and appropriate;
- (3) constituting the governing board and filling the chief executive position, and monitoring the board’s and the chief executive’s performance of their legal and organizational responsibilities;
- (4) holding periodic meetings of the board (and membership, if any);
- (5) setting and reviewing policies, particularly those addressing matters reserved to the board by law or the organizational documents, and providing direction to and oversight of management;
- (6) guarding the [organization’s] fiscal integrity and performance by adopting the budget, setting investment and spending policies, seeking appropriate resources, and exercising oversight over the [organization’s] assets, both investment and programmatic;
- (7) overseeing appropriate communication with the [organization’s] constituencies and the public; and

Nonprofit organizations sometimes differ from the standard corporate model in their governance.⁴⁰ Certain “state statutes permit the founder of a nonprofit corporation to include a provision in the articles of incorporation that requires the assent of the founder or another specified person or body to all or certain board decisions, or that vests authority over certain issues in a person or body.”⁴¹

Nevertheless, the fiduciary duties that the board owes the organization find much in common with corporate law.⁴² An analysis of recent board activities in the organizations discussed in this article must necessarily include both areas of law.

1. *The Duty of Care*

“The duty of care asks a director: (1) to be reasonably informed; (2) to participate in decisions; and (3) to do so in good faith.”⁴³ The business judgment rule (from for-profit corporate law), which has been applied consistently to nonprofit organizations, provides that an informed decision by the board of an organization about business

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- (8) establishing appropriate procedures for internal controls, including financial controls, legal compliance, and information flow to the board.

Id. § 320.

⁴⁰ *Id.* § 320 cmt. b(2).

⁴¹ *Id.*

⁴² *Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974); *La. World Exposition v. Fed. Ins. Co.*, 864 F.2d 1147, 1151 (5th Cir. 1989) (“The standard of care for a director of a nonprofit corporation was long held to be more demanding than that for a director of a for-profit business. The theory was that a nonprofit corporation was analogous to a public trust, and its directors were deemed its trustees. However, modern statutes and case law have altered that, and now the standard for nonprofit corporate directors is usually the same as that of their for-profit counterparts.”).

⁴³ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(a); *see also* CAFARDI & CHERRY, *supra* note 2, at 6–7. The phrase “best interests of the corporation” is key to an explication of a director’s duties. The term “corporation” is a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body. In determining the corporation’s “best interests,” the director has wide discretion in deciding how to weigh near-term opportunities versus long-term benefits as well as in making judgments where the interests of various groups within the shareholder body or having other cognizable interests in the enterprise may differ.

MODEL NONPROFIT CORP. ACT § 8.30, cmt. 1(2) (AM. BAR ASS’N 2008).

matters is presumed correct.⁴⁴ Many state statutes continue to require the additional responsibility of acting with the care of an ordinarily prudent person in similar circumstances, though the Model Nonprofit Corporation Act of 2008 has removed this standard.⁴⁵

2. *Duty of Loyalty*

The duty of loyalty mandates that directors act in the best interest of the organization and not for themselves or for another.⁴⁶ It is in this area of the law that there is a great deal of misstepping by boards, often causing regulators to become involved in the organization's governance affairs. If a director has interests that conflict with the organization, the director has the duty to disclose the conflict before the board takes action.⁴⁷ A director that knows of a corporate opportunity that may fall within the organization's future activities

⁴⁴ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(a)(2); Fishman, *supra* note 34, at 233.

⁴⁵ *E.g.*, S.C. CODE ANN. § 33-8-300(a)(2) (West, Westlaw through 2018 Act. No. 263). The business judgment rule enjoys wide judicial acceptance in the nonprofit context. "The purpose of the business judgment rule is to protect rational, informed, business decisions and to permit risk taking, innovation, and creative entrepreneurial activities, which are characteristic of nonprofit corporate enterprises." CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(a)(2).

⁴⁶ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(b)(1); *see also* Nixon v. Lichtenstein, 959 S.W.2d 854, 859 (Mo. Ct. App. 1997); *Stern*, 381 F. Supp. at 1014-16; MODEL NONPROFIT CORP. ACT § 8.70 (AM. BAR ASS'N 2008). One commentator stated as follows:

Some [state statutes] do not explicitly require a director to have an objectively reasonable belief that his actions are in the best interests of the corporation, with some adopting a more lenient standard that merely requires that the director have a subjective belief that his actions are in the best interests of the corporation or at most requires a showing that the director's belief is honest or in good faith. A few are silent on the issue of whether the director's belief will be evaluated by an objective or a subjective test, while some have adopted a different yet also lenient standard in that they do not impose an affirmative duty on directors to act in the best interests of the corporation. Other variations include a requirement that a director . . . act "in or not opposed" [to] the corporation's best interests or that he act "with a view to the interests of the corporation," a vague formulation that also appears to fall short of an affirmative duty to act in the best interests of the corporation.

MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 208 (2004).

⁴⁷ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(b)(2).

must disclose the transaction to the board and provide an opportunity for the board to act before engaging in such transaction.⁴⁸

The board of directors may approve a transaction between the organization and a board member, waive the organization's interest in a transaction between another person and a board member, or approve or waive any other conflict of interest of the board member. However, the board can only take these actions if, in good faith, the board reasonably determines that the transaction is both fair to and in the best interests of the organization or that the approval or waiver of the organization's interest in any other conduct is in the best interests of the organization.⁴⁹

If the organizational documents so allow, the board does have the power to alter fiduciary duties.⁵⁰ However, the board cannot do the following: (1) "[r]educe the duty of care . . . so as to permit a knowing violation of law, intentional misconduct, reckless conduct, or gross negligence";⁵¹ (2) [r]educe the duty of loyalty . . . in a manner that is manifestly unreasonable, taking into account the charitable nature of the organization";⁵² or (3) "[a]bsolve a fiduciary from the obligation to act in good faith."⁵³

⁴⁸ *Id.* § 3.03(b)(3). The duty of loyalty requires that the director or officer place the interests of the organization over any personal or individual interest. It further requires that directors not use their position to make a personal profit or to gain other personal advantage. A director must be sensitive to potential conflict, disclose the conflict before the board takes action, and, upon disclosure, have a disinterested board review the matter. The disclosure should be in writing and be fully recorded in the board minutes. Examples are listed throughout state statutes and the Model Nonprofit Corporation Act and include taking insider advantages, improperly using material nonpublic corporate information and usurping a corporate opportunity. A conflict of interest may occur directly or indirectly, for example, a conflict may arise from a family relationship or a director may have an investment relationship with an entity with which the corporation is dealing. The duty of loyalty requires a director be sensitive to potential conflict, disclose the conflict before the board takes action and upon disclosure, have a disinterested board review the matter. The disclosure should be in writing and fully recorded in the board minutes. *Id.*

⁴⁹ *Id.* § 3.03(b)(3).

⁵⁰ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 305 (AM. LAW INST. 2007).

⁵¹ *Id.* § 305(b).

⁵² *Id.* § 305(a).

⁵³ *Id.* § 305(c). The Restatement's comment to this rule says as follows:

Both corporate and trust law are essentially enabling regimes, setting forth default rules in the absence of direction to the contrary in the trust instrument or articles of incorporation and bylaws. Notably, both trust law and corporate law have recognized the power of the settlor or

3. *Duty of Obedience*

“Boards of [d]irectors are bound through the duty of [mission (obedience)] by the founding documents of a corporation (corporate articles and bylaws) in carrying out the corporation’s actions and in the expenditure of funds gifted to the corporation.”⁵⁴ Moreover, [t]he duty of obedience requires that the board of directors operate the organization for exempt purposes.⁵⁵ The board is responsible for knowing the content of the articles of incorporation, the bylaws, and all other founding documents and for assuring compliance. Procedures should be put in place so that the expectations are clear to those overseeing and those operating the organization. Maintaining nonprofit and tax exempt status is the duty of the board, as well as assuring that the proper tax and other required documents are filed (e.g., Form 990).⁵⁶

In addition, “the board of directors of a nonprofit is also responsible for setting the compensation for the executive director and for directing investments for the organization. Because of the complexity of finances and investments, the board is required to meet

incorporators (and subsequently the board, subject to ratification by members, if any) to provide an exculpatory clause defining certain behavior not to be a breach of fiduciary duty; to adopt a monetary shield to protect fiduciaries from the risk of personal financial harm arising out of the performance of fiduciary duties . . . ; and to permit indemnification and the purchase of director’s and officer’s liability insurance As limited by the requirements of law and the organizational documents . . . , the decisions to adopt such provisions are governed by the board’s general duties of loyalty and care.

Id. § 305 cmt. a.

⁵⁴ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(c); *see also In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999); *see also* Peter D. Jacobson & Soniya Keskar Mathur, *Health Law 2010: It’s Not All About the Money*, 36 AM. J.L. & MED. 389, 392–94 (2010) (discussing duty of obedience in context of *Manhattan Eye, Ear and Throat Hospital* and *Littauer v. Spitzer*, 715 N.Y.S.2d 575 (N.Y. App. Div. 2001), which “have generated an unclear outline of director obligations with respect to an organization’s mission,” and concluding that “the *Littauer* decision appears to limit the [*Manhattan Eye, Ear and Throat Hospital*] court’s reliance on the duty of obedience to preserve board obligations to the health care organization’s mission”).

⁵⁵ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(c).

⁵⁶ *Id.* § 3.03(c) (footnote omitted).

the ‘prudent person’⁵⁷ standard when making investment decisions.”⁵⁸

B. *State and Federal Law*

State statutes differ in the exact language and specific requirements for these duties, though for the most part states follow portions of the Model Nonprofit Corporate Act, Third Edition.⁵⁹ “For many aspects

⁵⁷ See RESTATEMENT (THIRD) TRUSTS § 90 & cmt. m; UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (NAT’L CONFERENCE OF COMM’RS OF UNIF. STATE LAWS 2006).

⁵⁸ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, § 3.03(c) (footnotes omitted).

⁵⁹ The RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS states the following:

Twenty-one state statutes (including Delaware’s) now permit a nonprofit corporation to adopt a charter amendment shielding liability for breaches of the duty of care. [See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (West, Westlaw through 81 Laws 2018); N.Y. BUS. CORP. LAW § 402(b) (McKinney, Westlaw through L.2018); GA. CODE ANN. § 14-3-202 (West, Westlaw through 2018 Legis. Sess.)]

. . . .

State-law monetary shields generally are unavailable in cases of breach of the duty of loyalty, typically self-dealing. However, depending on where the law locates the failure of fiduciaries to protect the organization from harm caused by inattentive performance, a simple exclusion for “breach of the duty of loyalty” could expose a board member to monetary liability for inadvertent breach.

RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS ch. 3, topic 2, intro. note (AM. LAW INST. 2007). Regarding a board’s removal of a director for failure to satisfy attendance requirements, see the MODEL NONPROFIT CORP. ACT § 8.08(c) (AM. BAR ASS’N, Proposed Draft 2017). “The board of directors may remove a director of a nonmembership corporation . . . [w]ith or without cause, unless the articles of incorporation or bylaws provide that directors may be removed only for cause.” MODEL NONPROFIT CORP. ACT, THIRD EDITION § 8.08(b) (AM. BAR ASS’N, Proposed Draft 2017). As to removal for cause, see *In re Grace v. Grace Inst.*, 226 N.E.2d 531 (N.Y. 1967); *In re Davidson v. James*, 568 N.Y.S.2d 397 (N.Y. App. Div. 1991). Citing *Grace*, the *Davidson* court held,

[T]he Board of Governors of respondent NAC had the inherent power to remove the petitioners for cause, where the petitioners’ commencement of personal injury actions against respondent NAC and searching its records for confidential information as to the nature and extent of insurance coverage, was in breach of their fiduciary obligations to NAC as members of its Board of Governors, and contrary to the interest of the organization.

of governance, state enabling statutes commonly provide default rules that operate in the absence of contrary provisions in the organizational documents.”⁶⁰ Nevertheless, “[f]or a nonprofit organization, [the articles of incorporation] contain such critical clauses as the organization’s statement of purpose and whether it has members.”⁶¹ The general requirement for drafting bylaws and the substantive requirements therefor are included in state statutes.

C. Board Investing

Board spending and investing are also matters for board oversight. The state version of the Uniform Management of Institutional Funds Act (UMIFA) and the Uniform Prudent Management of Institutional Funds Act (UPMIFA), or similar statute, are applicable to the investment and spending of nonprofit charitable organizations.⁶² The Acts allow an organization’s board to make decisions in keeping with the organization’s investment strategies.”⁶³

IV. THREE CASE STUDIES

Id. at 398 (citing *In re Grace v. Grace Inst.*, 226 N.E.2d at 533). The court added, “Petitioners have failed to make a showing warranting court intervention into the internal affairs of respondent NAC pursuant to § 618 of the Not-For-Profit Corporation Law where there is no indication that the petitioners’ removal was tainted by fraud or other wrongdoing.” *Id.* (citing *In re Scipioni v. Young Women’s Christian Ass’n*, 482 N.Y.S.2d 390, 390 (N.Y. App. Div. 1984)). Note, however, that the New York Not-for-Profit Corporation Law does not empower a board to remove a director without cause; only the membership (if any) has the right to do so. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 706(b)–(c) (McKinney, Westlaw through L.2018); *see also* *Lutz v. Tanglwood Lakes Cmty. Ass’n, Inc.*, 866 A.2d 471, 473–75 (Pa. Commw. Ct. 2005) (discussing interpretation of Pennsylvania statute requiring “proper cause” for director removal).

⁶⁰ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 320 cmt. d(2) (AM. LAW INST. 2007)

⁶¹ *Id.*

⁶² *Id.* § 335; UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (NAT’L CONFERENCE OF COMM’RS OF UNIF. STATE LAWS 2006). As of August 2018, UPMIFA had been adopted in all states and territories except Pennsylvania and Puerto Rico. PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT (UPMIFA) (UNIF. L. COMM’N 2006). UPMIFA section 8 provides that the “[act] applies to institutional funds existing on or established after [the effective date of this act]. As applied to institutional funds [then] existing . . . [,] this act governs only decisions made or actions taken on or after that date.” *Id.* § 8.

⁶³ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 335 cmt. b(1) (AM. LAW INST. 2007).

Most nonprofit organizations carry out their missions faithfully and have boards that promote and guide them in accordance with their organizational documents. But some do not abide by state or federal law. The three case studies below are not only examples of board behavior that gives rise to investigations but also serve as points of reference for discussing the regulation that is the subject of this Article. In reviewing the regulatory response to the situations discussed, one might ask whether having both the IRS and attorneys general involved in monitoring the governance of these organizations actually provides more oversight or whether dual regulation is fostering carelessness in state and federal oversight. If the attorneys general operate under the assumption that the IRS is monitoring governance, and vice versa, perhaps things are being missed. The three examples below provide evidence.

A. *Trump Foundation*

In June 2018, the New York Attorney General filed a lawsuit in the New York Supreme Court against Donald J. Trump, Donald J. Trump Jr., Ivanka Trump, Eric F. Trump, and the Donald J. Trump Foundation.⁶⁴ The Petition alleges that

[f]or more than a decade, the Donald J. Trump Foundation has operated in persistent violation of state and federal law governing New York State charities. This pattern of illegal conduct by the Foundation and its board members includes improper and extensive political activity, repeated and willful self-dealing transactions, and failure to follow basic fiduciary obligations or to implement even elementary corporate formalities required by law.⁶⁵

According to the Petition, the Foundation was incorporated as a “private New York not-for-profit corporation”⁶⁶ in 1987 and was granted 501(c)(3) status as a private foundation.⁶⁷ “The Foundation’s

⁶⁴ New York v. Donald J. Trump (N.Y. Sup. Ct. 2018), https://ag.ny.gov/sites/default/files/court_stamped_petition.pdf.

⁶⁵ *Id.*

⁶⁶ *Id.* at 4.

⁶⁷ *Id.* The Foundation’s private foundation status is classified as a § 509(a) organization. *Id.* One casebook gives the following definition:

stated mission is to ‘receive and maintain a fund . . . to [be] use[d] . . . exclusively for charitable, religious, scientific, literary[,] or educational purposes either directly or by contributions to organizations that qualify as exempt organizations under section 501(c)(3) of the Internal Revenue Code.’”⁶⁸ In 2016, the Foundation reported \$1 million in assets.⁶⁹

In the Petition, the New York Attorney General establishes the legal authority for bringing this case.⁷⁰ First, the Petition states that the “Attorney General is responsible for overseeing the activities of New York not-for-profit corporations and the conduct of their officers and directors”⁷¹ Moreover, “on behalf of the People of the State of New York,”⁷² the Attorney General can bring proceedings to, among other things, “dissolve a corporation,”⁷³ “enforce any [statutory] right given . . . to members, a director or an officer of a charitable

[A private] foundation is a nongovernmental, nonprofit organization with its own funds (usually from a single source, either an individual, family [,] or corporation) and program managed by its own trustees and directors, which was established to maintain or aid educational, social, charitable, religious, or other activities serving the common welfare primarily by making grants to other nonprofit organizations.

CAFARDI & CHERRY, *supra* note 2, at 911 (quoting F. EMERSON ANDREWS, PHILANTHROPIC FOUNDATIONS 11 (1956)). Interestingly, a 501(c)(3) organization is considered a “private foundation” unless it meets certain criteria in I.R.C. § 509(a). *Id.* at 912. Generally, section 509(a) states that the following are not private foundations: (1) “traditional public charities,” such as churches, schools, and hospitals; (2) “gross receipts organizations,” which “receive more than one-third of their support from gifts, grants, fees, and ‘gross receipts’ from admissions [or] sales of goods or services”; (3) “supporting organizations,” which “are not publicly supported but have a closely defined control or programmatic relationship with one or more public supported organizations”; and (4) organizations “testing for public safety.” *Id.* at 913–15 (citing I.R.C. §§ 170(b)(1)(A)(i)–(vi), 509(a)(1)–(4) (2018)). For more information, see *Trs. for the Home for Aged Women v. United States*, No. 79-1036-F, 1986 WL 3494 (D. Mass. Mar. 17, 1986); *Educ. Athletic Ass’n v. Comm’r*, 77 T.C.M. 1525 (1999); *Windsor Found. v. United States*, No. 76-0441-R, 1977 WL 1254 (E.D. Va. 1977); *Lapham Found., Inc. v. Comm’r*, 84 T.C.M. (CCH) 586 (2002); *Polm Family Found. v. United States*, 644 F.3d 406 (D.C. Cir. 2011).

⁶⁸ Petition at 4, *New York v. Donald J. Trump* (N.Y. Sup. Ct. 2018) (quoting Donald J. Trump Foundation, Certificate of Incorporation § 2 (Feb. 2, 1987)).

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 5.

⁷³ *Id.* (quoting N.Y. NOT-FOR-PROFIT CORP. LAW § 112(a)(5) (West, Westlaw through L.2018)).

corporation,”⁷⁴ and “seek damages and other appropriate remedies.”⁷⁵ New York’s not-for-profit statute forbids a charitable corporation from “distribut[ing] any part of its income to the directors or officers of the corporation,”⁷⁶ and also forbids a private foundation from “engag[ing] in any act of self-dealing which would result in the taxation of any amount involved with respect to any such act of self-dealing under section 4941 of the [Internal Revenue Code].”⁷⁷

The Petition continues, alleging insufficient Board oversight⁷⁸ and that the “Foundation’s Board existed in name only.”⁷⁹ It further states that the Board members individually failed to exercise their fiduciary duties, did not meet at all for nineteen years, and did not oversee the Foundation’s activities at all.⁸⁰ The Board had no policies in place for the direction of the Foundation, used no criteria for considering and approving grants, and never reviewed any annual reports, as required by law.⁸¹ The Petition claims that, because there was no functioning Board, “Mr. Trump ran the Foundation according to his whim.”⁸² The Foundation did not adopt a conflict-of-interest policy in accordance with both state and federal law.⁸³

The lawsuit further states the following:

[T]he Foundation was little more than a checkbook for payments to not-for-profits from Mr. Trump and entities that he owned. This resulted in multiple violations of state and federal law because payments were made using Foundation money regardless of the purpose of the payment. Mr. Trump

⁷⁴ *Id.* (quoting § 112(a)(7)).

⁷⁵ *Id.* (quoting § 112(a)(10)).

⁷⁶ *Id.* (quoting § 515(a)).

⁷⁷ *Id.* at 6 (quoting N.Y. EST. POWERS & TRUSTS LAW § 8-1.8(a)(2) (McKinney, Westlaw through L. 2018)).

⁷⁸ *Id.* at 9.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.* (citing N.Y. NOT-FOR-PROFIT CORP. LAW § 519 (West, Westlaw through L. 2018)).

⁸² *Id.*

⁸³ *Id.* at 10 (citing N.Y. NOT-FOR-PROFIT CORP. LAW § 715-A (West, Westlaw through L.2018)); N.Y. EST. POWERS & TRUSTS LAW § 8-1.9(d) (2018) (McKinney, Westlaw through L.2018)); *see also* INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, OMB NO. 1545-0056, FORM 1023, at 3, 4, 17 (2017) [hereinafter FORM 1023] (questions V.4a and V.5a, and Schedule C, Section 1, question 10); INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, OMB NO. 1545-0047, FORM 990, at 6 (2017) [hereinafter FORM 990] (questions VI.B.12a and VI.C.19).

used charitable assets to pay off the legal obligations of entities he controlled, to promote Trump hotels, to purchase personal items, and to support his campaign for president.⁸⁴

The Petition concludes by asking the state of New York to dissolve the Trump Foundation and distribute its remaining assets to other charitable organizations.⁸⁵

One might ask how for thirty years, if the allegations are correct, the Trump Foundation was permitted to function in this way? The state attorney general had the authority to monitor the organization and its board, and the IRS had access to the organization's Form 990s. The violations cited in the Petition state a complete lack of compliance on the part of the Foundation and a good deal of reckless self-dealing (e.g., "Board members failed to exercise their fiduciary duty to provide oversight and control of the organization for at least nineteen years. The Board has not met since 1999 and has not overseen the activities of the foundation in any way").

One of the problems with the Trump Foundation board was the inclusion of Trump's adult children, Donald Jr., Ivanka, and Eric, as board members, which raises questions of conflict of interest and self-dealing. All three, as well as the sitting President of the United States, have been named as defendants in the case.⁸⁶ The participation of numerous family members in the organization's board and management created a troubling environment all too common in private foundations controlled by families.⁸⁷

⁸⁴ Petition at 2, *New York v. Donald J. Trump* (N.Y. Sup. Ct. 2018); *see also* Connors, *supra* note 1.

⁸⁵ Petition at 40, *New York v. Donald J. Trump* (N.Y. Sup. Ct. 2018).

⁸⁶ *Id.* at 1.

⁸⁷ One article received insight on why family participation on a board could be problematic:

Lesley Rosenthal is the outgoing general counsel of Lincoln Center for the Performing Arts Board and a contributor to the Harvard University Law School's Forum on Corporate Governance and Financial Regulation. In a study entitled "Nonprofit Corporate Governance: The Board's Role," Rosenthal provided a nearly complete definition of what a nonprofit board should be and, by implication, what it should not be:

Board independence and board attention are of paramount importance in good nonprofit governance. The independence of the board is key because of the non-distribution constraint—nonprofits exist to serve the public interest, not to benefit owners or other private parties. Business or family relationships between

B. *Resnick Foundation*

Stewart and Linda Resnick created the Resnick Charitable Foundation in 1991.⁸⁸ At the time, Mr. Resnick was president, Mrs. Resnick was chairwoman and “four senior officials at Wonderful”⁸⁹ (the couple’s privately held company that is one of the nation’s largest tree nut growers)⁹⁰ were officers. Foundation officials had recently been questioned about the Foundation’s 2016 tax filing, which showed “\$50 million in outstanding loans to two companies whose owners supply nuts to the couple’s pistachio empire...”⁹¹ Because the loans made up 88% of the Foundation’s total assets, questions were raised as to whether indirect self-dealing has existed.⁹² Again, this raises the question, why did it take so long for any regulator to notice that inappropriate activity was being carried out by this board of directors? As stated above, the state attorney general had the authority to investigate this matter since board fiduciary duties were being violated and other acts of self-dealing were occurring. The IRS should have noticed sooner that the informational return raised serious questions.

C. *Goodwill Nebraska*

Nebraska Attorney General Doug Peterson began investigating Goodwill Omaha in 2016 for alleged wrongdoing on the part of the organization and its board of directors.⁹³ His findings were released in a report in June 2018 confirming alleged accounts that the organization

the organization or its executives and a board member or her firm are frowned upon and should be strictly scrutinized under a conflict of interest policy administered by independent directors. Even absent outright business or family relationships, a common shortcoming of nonprofit boards is that they are too small, too insular, or too deferential to the founder or chief executive.

Connors, *supra* note 1. See also Ruth McCambridge, *NY Attorney General Sues Trump and Family for Flagrant Misuse of Charity*, NONPROFIT Q. (June 15, 2018), <https://nonprofitquarterly.org/2018/06/15/ny-attorney-general-sues-trump-and-family-for-flagrant-misuse-of-charity/>.

⁸⁸ Resnick Foundation, CHARITY NAVIGATOR, <https://www.charitynavigator.org> (search charity search field for “Resnick Foundation”; then click on “Resnick Foundation”).

⁸⁹ See Fuller, *supra* note 1.

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² See *id.*

⁹³ McCambridge, *supra* note 1.

overpaid its executives, provided little support to the individuals it was organized to serve, and operated like a for-profit business directing profits from the store back into the business “in the form of growth capital and salaries.”⁹⁴ The Attorney General reported that “the public was deceived as to the charitable purpose of the stores”⁹⁵ and that the board was inattentive, resulting in poor “management practices.”⁹⁶ “[T]he leadership of Goodwill Omaha [justified] their focus on constant retail expansion by pointing to retail sales as furthering their mission programs’—but there [was] no evidence [that the money] was used for programs.”⁹⁷

The report indicated that the trustees failed to recognize a problem because of “a consent agenda” in which an executive committee with an inappropriately large role examined trustee matters before the trustees did so.⁹⁸

The executive “committee also conducted the review of the CEO and set his salary.”⁹⁹ “The report says, ‘It was evident in our interviews of the former board members that they were shocked by much of the reporting in the *World-Herald*’s series exposing abuses . . . [It] seems self-evident . . . those directors were not sufficiently engaged.’”¹⁰⁰ Investigators found that for years, none of the store revenue was used to support the job programs that were part of the organization’s mission and there was “no correlation at all” between how the charity was performing its true mission and what executives were paid and that excessive pay further deprived Goodwill of dollars for its mission.¹⁰¹

V. CURRENT GOVERNANCE THEORIES

The examples discussed above illustrate the types of activities being overlooked by regulators tasked with monitoring nonprofit organizations, which are subject to both state and federal law.

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.* (quoting PETERSON, *supra* note 6, at 7).

⁹⁸ *Id.* (quoting PETERSON, *supra* note 6, at 37).

⁹⁹ McCambridge, *supra* note 1.

¹⁰⁰ *Id.* (quoting PETERSON, *supra* note 6, at 38).

¹⁰¹ *Id.* (quoting Henry J. Cordes, *AG’s Goodwill Probe Faults Excessive Pay That Harmed Mission but Says Nonprofit Is Back on Track*, OMAHA WORLD-HERALD (June 27, 2018), https://www.omaha.com/news/metro/ag-s-goodwill-probe-faults-excessive-pay-that-harmed-mission/article_76b1989e-2f30-5b73-abd4-b7ed4b0ac3ee.html).

Specifically, all nonprofit organizations, trusts, or unincorporated associations that seek 501(c)(3) status must complete an IRS Form 1023 application.¹⁰² The IRS reviews this form and determines whether or not an organization is granted this status, allowing for various federal tax exemptions. Organizations that are granted this status may seek gifts that will be considered tax deductible by the IRS, giving a tax break not only to the organization but also to the donor (individual or other I.R.C. § 501(c)(3) organization).¹⁰³ With few exceptions, such a benefit is unique to these charitable nonprofit tax-exempt organizations.¹⁰⁴ Such a system, not uncommon in other areas of the law (antitrust, employment), requires that both the state and the federal government provide oversight of these organizations. It might be said that these dual roles are critical and at the heart of our form of government because charitable nonprofit organizations, some say, enhance a “pluralistic society,” allowing the voices of the citizenry to be heard through the tax dollar support they provide these organizations.¹⁰⁵ Scholars in this area disagree on whether dual oversight is most effective,¹⁰⁶ whether it preempts state authority and therefore, undermines principles of federalism,¹⁰⁷ or whether it is an overreach that is outside the IRS’s jurisdiction.¹⁰⁸

A. *Dual Oversight*

“[S]tates and the federal government share oversight authority with

¹⁰² See Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, IRS, <https://www.irs.gov/forms-pubs/about-form-1023> (last updated May 24, 2018). If all of the requirements for exemption have been met, then the IRS, after reviewing Form 1023, has the authority to grant exemption.

¹⁰³ CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, at 31; I.R.C. § 501(c)(3) (2018); Treas. Reg. § 1.501(c)(3)-1 (1960).

¹⁰⁴ See CAFARDI & CHERRY, *supra* note 2, at 572. Most other tax-exempt organizations cannot attract tax deductible donations. See *Id.* While there are currently twenty-nine 501 sections, only the (c)(3), (c)(4) in instances where the organization is performing a charitable function and the gift is restricted to that use, and (c)(8) organizations, for specific charitable purposes. See generally *Id.* at 572–624. Veterans organizations, I.R.C. § 501(c)(19), may also attract and accept tax deductible gifts because of our nation’s desire to assist veterans for their service. See generally *Id.* at 572–624.

¹⁰⁵ See *Walz v. Tax Comm’n*, 397 U.S. 664, 669 (1970) (Brennan, J., concurring).

¹⁰⁶ E.g., Mayer, *supra* note 8.

¹⁰⁷ E.g., Fishman, *supra* note 3.

¹⁰⁸ E.g., Hopkins, *supra* note 3.

respect to nonprofits,”¹⁰⁹ though some oversight “reflects a division of responsibilities, . . . as opposed to an overlap of responsibilities.”¹¹⁰ This overlap causes the most disagreement and concern among scholars, specifically in the area of fiduciary duties and regulation of boards of directors. While “the states have broad authority to impose such duties and enforce them,”¹¹¹ the federal government has “established some similar duties through excise tax regimes.”¹¹² And while “[c]ertain governance-related duties continue to primarily be imposed and enforced by the states,”¹¹³ such as the duty of care and the duty of obedience,¹¹⁴ the federal government has also set forth “best practices” in this governance area.¹¹⁵ “[S]tates have the broadest authority when it comes to the use of a nonprofit’s assets” with regard to the duty of mission (obedience), but the federal government also has a role in overseeing board functions because it requires that governing documents (articles of incorporation and bylaws), which fall under state law, include a dissolution clause, which satisfies the nondistribution constraint¹¹⁶ and a statement that there will be no private inurement or political activity in order to meet federal requirements.¹¹⁷

As one scholar posits, there is dual authority for imposing “registration, reporting, and related public disclosure requirements” where charitable nonprofit organizations are concerned, and oftentimes the states use federal requirements to their advantage when accepting submission of federal forms to meet state requirements.¹¹⁸ Most overlap occurs in governance issues, “particularly transactions with governing board members, officers, and other insiders that are subject both to the state law duty of loyalty and the federal prohibition on private inurement”¹¹⁹ Moreover, “there is both substantive and functional overlap, since the states and the federal government both set and enforce standards in this area.”¹²⁰ However, less overlap exists

¹⁰⁹ Mayer, *supra* note 8, at 948.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 949–50.

¹¹² *Id.* at 950.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 951.

¹¹⁸ *Id.* An example includes charitable solicitation laws, which require annual financial returns. Many states accept the IRS Form 990 as sufficient.

¹¹⁹ *Id.*

¹²⁰ *Id.*

“with respect to governance standards relating to the state law duty of care, in that the federal government suggests certain best practices by inquiring about them on the Form 990 but does not actually require any particular practices (except with respect to private foundations).”¹²¹

The advantages of a dual system include having “at least two primary regulators . . . with partially but not completely overlapping responsibilities,”¹²² improved efficiency, and the potential for greater expertise.¹²³ Some disadvantages include having little development in the area of expertise because of limited information sharing, the potential for duplication, and congressional proposals to further empower the IRS in this area.¹²⁴ One such Congressional proposal would extend federal oversight into areas of governance and fiduciary duties.¹²⁵ But Professor Marion Fremont-Smith makes clear that in her opinion a dual system may be the appropriate mechanism for addressing the consistent and varied bad board behaviors that need oversight.¹²⁶

B. Preemption of State Authority and Undermining of the Principles of Federalism

As early as 2009, Professor James Fishman¹²⁷ stated that the IRS had initiated a corporate governance initiative.¹²⁸ He states that the intervention by the IRS into an area traditionally “the preserve of state nonprofit corporate law[] has little relationship to issues of tax compliance.”¹²⁹ Rather, “[t]his corporate governance initiative has been accomplished in the face of [IRS] recognition that it has no statutory authority relating to these issues.”¹³⁰ He argues that despite a lack of authority, the Senate Finance Committee and House Ways and Means Committee began calling for greater accountability in the

¹²¹ *Id.*; see also ANTHONY J. BELLIA JR., *FEDERALISM* 216 (2011) (discussing concept of “dynamic federalism”).

¹²² Mayer, *supra* note 8, at 955.

¹²³ *Id.* at 957.

¹²⁴ *Id.* at 957–58.

¹²⁵ See Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613, 615 (2005).

¹²⁶ FREMONT-SMITH, *supra* note 46.

¹²⁷ James J. Fishman is a professor at Pace University School of Law. Fishman, *supra* note 3.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 548.

nonprofit sector as early as 2006.¹³¹ Fishman continues, saying that Congress encouraged the IRS, “the primary federal regulator of charities . . . to increase its monitoring of charities.”¹³² After passage of the Sarbanes-Oxley Act¹³³ in 2002, nonprofits began responding by initiating “best practices,” and in 2004 the IRS revamped its forms (both the Form 1023 and Form 990) to include a series of questions regarding the governance practice of organizations that were filing.¹³⁴ Fishman states that while “these are ‘recommended’ but not yet officially required to obtain exemption, . . . it would be a reckless charity to ignore the Service’s suggestions,”¹³⁵ even though Congress has not yet “mandated the adoption of [certain] governance practices as a condition of tax exemption.”¹³⁶ While Form 1023 and its instructions suggest that exempt determinations will not be denied based on governance issues,¹³⁷ “the Service has denied exemptions because of the lack of an independent board, some independent members, or a conflict of interest policy.”¹³⁸ Given this, little or no guidance has been given to IRS auditors or applicants.¹³⁹ Fishman posits that these questions became the standard for an organization to be granted tax-exempt status; all the while the IRS had no real authority to seek and require this information in its decision-making

¹³¹ *Id.* at 546.

¹³² *Id.* at 547; *see also* Treas. Reg. § 601.101(a) (1960) (recognizing IRS authority over “assessment and collection of all taxes”).

¹³³ Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 78d–3, 78, 7201, 7202, 7211–20, 7231–34, 7241–46, 7261–66; 18 U.S.C. §§ 1348–50, 1514A, 1519, 1520 (2018).

¹³⁴ Fishman, *supra* note 3 at 560. Examples of governance questions from Form 1023 include the following: “Are any of your officers, directors, or trustees related to each other through family or business relationships?”; “Do you or will the individuals that approve compensation arrangements follow a conflict of interest policy?”; “Do you or will you record in writing the decision made by each individual who decided or voted on compensation arrangements?”; “Do you or will you have any leases, contracts, loans, or other agreements with any organization in which any of your officers, directors, or trustees are also officers, directors, or trustees, or in which any individual officer, director, or trustee owns more than a 35% interest?” FORM 1023, *supra* note 83, at 3, 4.

¹³⁵ Fishman, *supra* note 3, at 560.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ Fishman, *supra* note 3, at 562 (citing BONNIE S. BRIER, ADVISORY COMM. ON TAX EXEMPT & GOV’T ENTITIES, THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES 33 (2008)).

¹³⁹ Fishman, *supra* note 3, at 562; *see, e.g.*, IRS, IRS TRAINING MATERIALS—GOVERNANCE (2018), <https://www.irs.gov/charities-non-profits/irs-training-materials-governance>.

processes.¹⁴⁰

As proof that there has been increased involvement by the IRS, Fishman states that in 1942, “[t]he Treasury Department required all tax-exempt organizations to file an annual information return.”¹⁴¹ The form was two pages, asked only three questions, and requested an income statement and balance sheet.¹⁴² Today, since the Form 990 was revamped in 2006, the form is twelve pages and asks a great variety of governance questions, though only for organizations whose gross income exceeds \$200,000.¹⁴³ Smaller organizations must submit EZ forms, which are much shorter and ask fewer governance questions.¹⁴⁴

C. IRS Regulation Through Private Benefit

One prominent practitioner, Mr. Bruce Hopkins,¹⁴⁵ states in a

¹⁴⁰ Fishman, *supra* note 3, at 548; Hopkins, *supra* note 3.

¹⁴¹ Fishman, *supra* note 3, at 564.

¹⁴² Fishman, *supra* note 3, at 564–65; *see also* Robert M. Howard & David C. Nixon, *Local Control of the Bureaucracy: Federal Appeals Courts, Ideology, and the Internal Revenue Service*, 13 WASH. U. J.L. & POL’Y 233, 245 (2003). Congress has a “strong preference for making policy choices itself rather than leaving them to the Treasury.” John F. Coverdale, *Chevron’s Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead*, 55 ADMIN. L. REV. 39, 87 (2003). When Congress decides to leave policymaking to the Treasury, it normally does not rely on the general delegation of authority in I.R.C. § 7805 but delegates specific regulatory authority. *Id.* at 87 n.310..

¹⁴³ *990 Series Which Forms Do Exempt Organizations File Filing Phase In*, IRS, <https://www.irs.gov/charities-non-profits/form-990-series-which-forms-do-exempt-organizations-file-filing-phase-in> (last updated July 17, 2018).

¹⁴⁴ *See id.*

¹⁴⁵ Mr. Hopkins is very experienced in tax-exempt law:

[He] concentrates on the representation of tax-exempt organizations, practicing with the Bruce R. Hopkins Law Firm, LLC, in Kansas City, Missouri. He is the Professor from Practice at the University of Kansas School of Law. He has authored or coauthored over 40 books on nonprofit law subjects, including *A Nonprofit Lawyer*; *The Law of Tax-Exempt Organizations, Eleventh Edition*; *The Tax Law of Charitable Giving, Fifth Edition*; *The Law of Fundraising, Fifth Edition*; *Bruce R. Hopkins’ Nonprofit Law Dictionary*; *Fulfilling a Dream: The Ultimate Law Degree*; *How to be a Successful Philanthropist*; and *Beware the Commerciality Doctrine and Other Nonprofit Law Poetry*. He writes a monthly newsletter, the *Bruce R. Hopkins’ Nonprofit Counsel*. He is listed in the Best Lawyers in America, for Nonprofit Organizations/Charities Law. He earned his JD and LLM at the [George Washington] University, his SJD at the University of Kansas, and his BA at the University of Michigan. He is a member of the bars of the District of Columbia and the state of Missouri.

recent tax article that “[t]he IRS is unlawfully—and unfairly—engaging in significant efforts to regulate the governance affairs of the nation’s public charities and other categories of tax-exempt organizations It is trying to dictate the composition of charities’ governing boards, doing so by abusing its [authority to] grant recognition of or revoke exempt status.”¹⁴⁶

Mr. Hopkins believes, more specifically, that the IRS is usurping this power to regulate governance through the “private benefit doctrine.”¹⁴⁷ He cites many Private Letter Rulings (PLRs) and some cases to document this increasing encroachment,¹⁴⁸ with the biggest concern being that PLRs are not authoritative guidance from the IRS.¹⁴⁹ This type of issuance is not subject to notice or public comment.¹⁵⁰ Hopkins questions whether the IRS has jurisdiction in the area of nonprofit governance because, as he sees it, the role of the IRS is to provide “taxpayer services, in the form of easily understandable information and prompt answers to questions, to make it as simple as possible for people and firms to pay their taxes.”¹⁵¹ Further, he states that “the IRS is essentially the tax collection and tax law enforcement agency for the federal government [As] a tax regulation states[,] ‘[t]he Internal Revenue Service is a bureau of the Department of the Treasury under the immediate direction of the Commissioner of Internal Revenue.’”¹⁵²

1. *Private Benefit Doctrine*

The private benefit doctrine is an application of the operational test, which is one of the tests an organization must meet to be granted 501(c)(3) status as a public charity.¹⁵³ Treasury Regulation section 1.501(c)(3)-1(c)(1), provides that:

Hopkins, *supra* note 3, at 4 n.1.

¹⁴⁶ *Id.* at 4.

¹⁴⁷ *Id.* at 11.

¹⁴⁸ *Id.* at 11, 13–15

¹⁴⁹ *Id.* at 16.

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 7.

¹⁵² *Id.* (quoting Treas. Reg. § 601.101(a) (1972)).

¹⁵³ See CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, at 73. “Private benefit does not involve a benefit to insiders; rather it involves a benefit to private as opposed to public interests. An organization is not operated for exempt purposes unless it serves a public rather than a private interest.” *Id.* at 73.

[a]n organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.¹⁵⁴

“An organization is not organized or operated exclusively for [charitable purposes] unless it serves a public rather than a private interest.”¹⁵⁵ Thus, an organization must “establish that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”¹⁵⁶

Case law states, “[w]hether an organization is operated exclusively for exempt purposes is a factual determination to be based on the administrative record.”¹⁵⁷ Contrary to what one might think, the term “exclusively” does not “mean ‘solely’ or ‘absolutely without exception.’”¹⁵⁸ Rather, a court determines that an organization is not organized “exclusively” for a charitable purpose if it finds “the presence of a single [nonexempt] purpose [that is] substantial in nature, . . . regardless of the number or importance of truly [exempt] purposes.”¹⁵⁹ A court always looks to “whether the benefits flowing to private persons are incidental to the main purpose of the organization, not whether those benefits are substantial.”¹⁶⁰ Private benefit occurs when more than an insubstantial benefit is directed toward an individual or a group.¹⁶¹

While the most common example of private inurement or private benefit is excess compensation, several other forms can arise, especially with sales of property and transactions involving lending and rental arrangements. Self-dealing transactions by private foundations may, in certain circumstances, amount to instances of

¹⁵⁴ Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960).

¹⁵⁵ *Id.* § 1.501(c)(3)-1(d)(1)(ii).

¹⁵⁶ *Id.*

¹⁵⁷ *Westward Ho v. Comm’r*, 63 T.C.M. (CCH) 2617 (1992) (citing *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 357 (1978)). The burden of proof is on the Petitioner. *Id.*

¹⁵⁸ *Id.* (quoting *Church in Boston v. Comm’r*, 71 T.C. 102, 107 (1978)).

¹⁵⁹ *Id.* (quoting *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945)).

¹⁶⁰ *Id.* (citing *Ky. Bar Found. v. Comm’r*, 78 T.C. 921, 926 (1982)).

¹⁶¹ *Id.*

private inurement or private benefit: “(1) sale or exchange, or leasing, of property between an organization and a private individual; (2) lending of money or other extensions of credit between an organization and a private individual; (3) furnishing goods, services, or facilities between an organization and a private individual; (4) payment of compensation (or payment or reimbursement of expenses) by an organization to a private individual; and (5) transfer to, or use by or for the benefit of, a private individual of the income or assets of an organization.”¹⁶² For example, one case dealt with a tax-exempt organization that sold a hospital at a low price “to insiders (board members, doctors on staff)” who, “within two years, . . . re-sold the hospital for almost twice what they had paid.”¹⁶³ The Tax Court found that the IRS properly revoked the organization’s tax-exempt status because private inurement existed.¹⁶⁴

2. Case Law and IRS Private Letter Rulings

In, *Bubbling Well Church v. Commissioner*,¹⁶⁵ noted as faulty court analysis in this area by Hopkins, Bubbling Well filed an application for exemption under section 501(c)(3), claiming to be a church.¹⁶⁶ The IRS denied the request, holding that Bubbling Well failed to show that it qualified for exempt status under section 501(c)(3) based on its inability to show that it was not operated for the private benefit of the owner, the Harberts family,¹⁶⁷ stating

To qualify for exemption under section 501(c)(3), petitioner has the burden of showing (1) that it was organized and operated exclusively for religious or charitable purposes, (2) that no part of its earnings inured to the benefit of a private individual or shareholder, and (3) that no substantial part of its activities consisted of the dissemination of propaganda or otherwise attempt[ed] to influence legislation or engaging in

¹⁶² BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 435 (7th ed. 1998).

¹⁶³ CAFARDI & CHERRY, *supra* note 2, at 115 (discussing Anclote Psychiatric Ctr. v. Comm’r, 76 T.C.M. (CCH) 175 (1998)).

¹⁶⁴ *Anclote Psychiatric Ctr.*, 76 T.C.M. (CCH) at 17.

¹⁶⁵ *Bubbling Well Church of Universal Love, Inc. v. Comm’r*, 74 T.C. 531 (1980), *aff’d*, 670 F.2d 104 (9th Cir. 1981).

¹⁶⁶ *Id.*

¹⁶⁷ *See id.*

political activity.”¹⁶⁸

The U.S. Tax Court came to this conclusion because the Harberts were the only voting members of their entity, they comprised the only members of the board, and “nothing [was] shown in the statement of income and expenses as budgeted or expended for the care of the needy, the sick, or the imprisoned, traditionally the beneficiaries of the ministrations of churches.”¹⁶⁹ The IRS requested a list of the names and addresses of the organization’s active members along with an itemized statement of income and expenses.¹⁷⁰ The Petitioner declined to properly answer and instead gave vague answers.¹⁷¹

Hopkins believes further, that in recent years, the IRS has chosen to state its position on nonprofit governance issues through its application and reporting forms¹⁷² and through the issuance of PLRs, oftentimes citing the private benefit doctrine. Several PLRs state that having only two individuals on a board automatically proves private benefit in violation of the requirements of section 501(c)(3).¹⁷³ In one PLR, the organization was created “[t]o provide fertility services at no cost to married and single women who desire to have children.”¹⁷⁴ The “[b]oard of [d]irectors consist[ed] of [only] two individuals[:.]” a father and son.¹⁷⁵ The president was the father, and the son was the secretary/treasurer.¹⁷⁶ The IRS stated that the organization did “not serve a public purpose as required by section 1.501(c)(3)-1(d)(1)(ii)” and thus could not be exempt.¹⁷⁷ Further,

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more of the purposes...unless it serves a public rather than a private interest. An organization that serves a private interest other than incidentally, is not entitled to exemption section 501(c)(3). Thus, although an organization’s operations may be deemed to be beneficial to the public, if it also serves private

¹⁶⁸ *Id.* at 534.

¹⁶⁹ *Id.* at 536.

¹⁷⁰ *Id.* at 533.

¹⁷¹ *Id.*

¹⁷² See FORM 1023, *supra* note 83; FORM 990, *supra* note 83.

¹⁷³ See, e.g., I.R.S. Priv. Ltr. Rul. 200737044 (Sept. 14, 2007).

¹⁷⁴ I.R.S. Priv. Ltr. Rul. 200736037 (Sept. 7, 2007).

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

interests other than incidentally[,] it is not entitled to exemption.¹⁷⁸

The IRS made it clear that to qualify for exemption, the benefit to a private interest must be incidental and one that naturally accompanies the benefits to the public benefit.¹⁷⁹ The IRS stated that it was “significant that M is your founder, your sole financial donor, and your principal sperm donor” and that, “taking into account your structure, governance[,] and operations, your activities result in the provision of more than an incidental level of private benefit to M and his family.”¹⁸⁰

Other reasons for denial of exemption include the following: (1) an organization lacks an independent board, according to the IRS;¹⁸¹ (2) two individuals are exercising “absolute control” over the organization;¹⁸² (3) and three directors have “unfettered control over [the] organization and its assets.”¹⁸³ The IRS also views one-person boards as evidence of private benefit¹⁸⁴ and finds that “close control by a few individuals without a system for public oversight[] creates an environment for potential abuse and insider benefit as there are no defined roles for responsibilities for [the] board or policies setting forth their duties and the handling of [the organization’s] finances.”¹⁸⁵

The IRS goes further in ruling that an organization with a board composed of five individuals violates section 501(c)(3) in part because the entity is governed by a “small group of individuals who have exclusive control over the management of [the entity’s] funds and

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*; Rev. Rul. 75-196, 1975-1 C.B. 155.

¹⁸⁰ I.R.S. Priv. Ltr. Rul. 200736037 (Sept. 7, 2007).

¹⁸¹ I.R.S. Priv. Ltr. Rul. 201252021 (Dec. 28, 2012); *see* I.R.S. Priv. Ltr. Rul. 200830028 (July 25, 2008).

¹⁸² I.R.S. Priv. Ltr. Rul. 200843032 (Oct. 24, 2008).

¹⁸³ I.R.S. Priv. Ltr. Rul. 200845053 (Nov. 7, 2008).

¹⁸⁴ *See* I.R.S. Priv. Ltr. Rul. 201009015 (Mar. 5, 2010).

¹⁸⁵ I.R.S. Priv. Ltr. Rul. 201325017 (June 21, 2013). In this PLR, the IRS held that petitioner did not qualify for exemption under section 501(c)(3) as synagogue because it “fail[ed] the operational test and lack[ed] control and discretion of . . . funds.” *Id.* Rather, it said, “As you have been unable to document the public benefit of the improvements done to this facility, you have not proven your assets will not inure to insiders or be used to privately benefit certain individuals.” *Id.* The IRS found the following to be evidence of private benefit: (1) two board members were related; (2) the board “allow[ed] a non-board member, who [was] related to the other board members, to write checks”; and (3) the board “executed capital building improvements on a [privately owned] facility” with no supporting documentation. *Id.*

operations.”¹⁸⁶ And a large group of rulings by the IRS deal with whether or not the boards of directors of healthcare organizations fulfill the requirement for community representation on the board, another IRS provision that is not reflected specifically in the statute.¹⁸⁷

VI. FOR-PROFIT GOVERNANCE COMPARISON

As discussed earlier in this article, much of nonprofit law finds its genesis in for-profit corporate law, so a brief review of the applicable law seems appropriate.¹⁸⁸ Charitable nonprofit organizations in colonial America began by imitating for-profit corporate law.¹⁸⁹ For decades, states applied for-profit law when dealing with nonprofit corporate issues, and even as nonprofit corporate law grew in existence, much of it was fashioned on the for-profit law of the state.¹⁹⁰

Since the advent of the Sarbanes-Oxley Act in 2002 (which applies to publicly held for-profit corporations but was adopted by nonprofit organizations through the establishment of “best practices”), and the development of hybrid organizations, the similarities have continued. Further, “[t]he duties of directors of nonprofit corporations, particularly in recent years, have come to resemble those of directors of business corporations[] because of the change in function of the typical corporate charity.”¹⁹¹ Moreover, “[e]ven before adoption of

¹⁸⁶ I.R.S. Priv. Ltr. Rul. 201421022 (May 23, 2014).

¹⁸⁷ See, e.g., I.R.S. Priv. Ltr. Rul. 201436050 (Sept. 5, 2014) (denying tax exemption as charitable organization to health care organization partially because its six-member board of directors “[did] not have a majority of directors representing the community”); I.R.S. Priv. Ltr. Rul. 201440020 (Oct. 3, 2014) (denying tax exemption to health care organization, in part, because its twenty-eight-person board (nearly all physicians) did not represent “broad interests of the community”); I.R.S. Priv. Ltr. Rul. 201525014 (June 19, 2015) (denying tax exemption to organization with one director because, in part, it “[did] not have a community-based board”); I.R.S. Priv. Ltr. Rul. 200828029 (July 11, 2008) (denying charitable tax-exempt status to organization, in part, because not operated by “community-based board of directors” (or because board “lack[ed] members who [were] representative of the community”)).

¹⁸⁸ See *supra* Part III.

¹⁸⁹ See Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437 (2005).

¹⁹⁰ See James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 *EMORY L. J.* 617, 641–42 (1985); Kelley, *supra* note 189, at 2462.

¹⁹¹ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS ch. 3, topic 1, intro. note, reporters’ note 2 (AM. LAW INST. 2007). “As Bayless Manning observed of the basic difference between a trustee and a director: ‘the concept of the prudent investor was created precisely to differentiate a trustee from the wider

modern nonprofit-corporation statutes, courts began to apply corporate rather than trust standards to directors of nonprofit corporations that operated a complex enterprise.”¹⁹² With regard to independent board members, “[i]t has long been common to emphasize a distinction between ‘inside’ and ‘outside’ directors, without clarifying the precise meaning of those terms[;]”¹⁹³ also, “[a] director may have a significant relationship with senior executives of a corporation and still be disinterested with respect to a particular transaction or conduct, or may lack a significant relationship with the senior executives and nevertheless be interested with respect to the transaction or conduct.”¹⁹⁴ Both of these board practices are adopted in most nonprofit statutes.

With regard to boards composed of related individuals or close friends, “[w]hat appears to be disinterested board approval may be disregarded by a court where the board is in fact subject to a controlling influence by a director who is interested in the transaction or conduct.”¹⁹⁵ Nevertheless, “[i]t is not intended that a person would be treated as subject to a controlling influence, and therefore interested, solely because of a long-time friendship or other social relationship, or solely because of a long-time business association through service on the same board of directors or other relationship not involving pecuniary dealing.”¹⁹⁶ When nonprofit board members are from the for-profit corporate world, it is not surprising that there are misunderstandings and violations occur.

The for-profit world has dealt extensively with the issue of excess

universe of business risk-taking, the very universe in which the board of directors is expected to live and operate.” *Id.* (quoting Bayless Manning, *The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1493 (1984)).

¹⁹² *Id.* For a case supporting the proposition that the business judgment rule does not apply to breaches of the duty of loyalty, see *Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1016 (D.D.C. 1974) (discussing instances in which defendant trustees engaged in self-dealing). See also *Summers v. Cherokee Children & Fam. Serv., Inc.*, 112 S.W.3d 486 (Tenn. App. 2002), in which the appeals court rejected application of the business judgment rule in a suit by the attorney general of Tennessee to dissolve two nonprofit corporations whose fiduciaries were essentially looting its assets; RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT § 365 (AM. LAW INST. 2007).

¹⁹³ PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.34 cmt. b (AM. LAW INST. 1994).

¹⁹⁴ *Id.* § 1.23 cmt.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

compensation, and the legal analysis is easily transportable to the nonprofit world.¹⁹⁷ For example, the Ninth Circuit used a five-part test to determine the reasonableness of executive compensation that could easily be used in the tax-exempt sector.¹⁹⁸ The five factors were as follows: (1) What was the employee's role in the organization?; (2) How does the compensation compare to what similarly situated organizations pay to employees performing similar services?; (3) What are the character and condition of the organization?; (4) Does a conflict of interest exist?; and (5) Do any internal inconsistencies exist in the organization's treatment of compensation payments to the employee? (How does this person's compensation compare to that of other employees of the organization?).¹⁹⁹ And of course, where courts are reviewing decisions by a nonprofit board, the business judgment rule is applicable.²⁰⁰

VII. POLICY CONSIDERATIONS

The policy considerations, some of which are discussed earlier in this article as part of various scholars' and practitioners' theories surrounding the IRS's authority to address governance issues, fall into several camps. Some believe that the IRS is undermining federalism and preempting state authority,²⁰¹ others that the IRS is involved in agency overreaching,²⁰² and yet others that dual federal agency and state oversight in this area is not only appropriate but effective.²⁰³

The preemption argument begins as follows:

The formal theory of federalism posits that our political system places limits on congressional action through states' representation in Congress, and the procedural safeguards that function through each state's constituency to restrain the ability of the federal government to reach beyond its powers. When congressional action threatens to infringe upon state sovereignty, the states' interest in preserving the individual liberties of the citizens is enforced through procedural safeguards inherent in the structure of the federal government

¹⁹⁷ See *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241 (9th Cir. 1983).

¹⁹⁸ *Id.* at 1245–48.

¹⁹⁹ *Id.*

²⁰⁰ See *supra* Section III.A.1.

²⁰¹ See *supra* notes 125–139 and accompanying text.

²⁰² See *supra* notes 148–163 and accompanying text.

²⁰³ See *supra* notes 111–124 and accompanying text.

through state participation in federal government action.²⁰⁴

This representation, however, becomes more difficult when the powers have been delegated to administrative agencies, like the IRS. And while neither a *Chevron* analysis²⁰⁵ (does not apply because the IRS has no congressionally delegated authority here) nor *Skidmore* analysis²⁰⁶ (since the claim is that the regulation is not occurring through a legally delegated authority and not based on official duty) is required,²⁰⁷ the IRS's initiative in the nonprofit corporate governance area supersedes its proper role.²⁰⁸

Another theory is that the IRS is regulating where it has no authority to do so and that, by stepping into this area through the "private benefit doctrine", it has "abus[ed] its authority"²⁰⁹ and violated the law.²¹⁰ Further, this claim asserts as evidence the statement by then-IRS Commissioner Miller in a 2007 speech discussing the IRS's role in nonprofit governance: "[w]hile a few continue to argue that governance is outside our jurisdiction, most now support an active IRS that is engaged in this area."²¹¹

Dual oversight, which supports dual sovereigns,²¹² has been trending in federalism jurisprudence and is moving "away from efforts to enforce mutually exclusive spheres of authority and toward

²⁰⁴ Fishman, *supra* note 3, at 580.

²⁰⁵ *Chevron v. Nat. Res. Def. Council*, 467 U.S. 837 (1984). *Chevron* deference applies "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority." Jacob E. Gersen, *Overlapping and Underlapping Jurisdiction in Administrative Law*, 2006 SUP. CT. REV. 201, 218 (citing *United States v. Mead*, 533 US 218 (2001)).

²⁰⁶ *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

²⁰⁷ Fishman, *supra* note 3 at 548–49.

²⁰⁸ *Id.*

²⁰⁹ Hopkins, *supra* note 3, at 4, 18.

²¹⁰ *Id.*

²¹¹ *Id.* at 6 (quoting Steven T. Miller, Comm'r, Internal Revenue Serv. Speech at 24th Annual Georgetown University Law School Conference on Representing and Managing Tax-Exempt Organizations (Nov. 10, 2007)); see also IRS' Miller Addresses Philanthropy Roundtable, PLANNED GIVING DESIGN CTR., <https://www.pgdc.com/pgdc/irs-miller-addresses-philanthropy-roundtable> (last updated May 18, 2011).

²¹² Jacob E. Gersen, *Overlapping and Underlapping Jurisdiction in Administrative Law*, 2006 SUP. CT. REV. 201, 236–37 (citing MARTIN H. REDISH, *THE CONSTITUTION AS POLITICAL STRUCTURE* 26 (1995); Alpheus Thomas Mason, *The Role of the Court*, in *FEDERALISM: INFINITE VARIETY IN THEORY AND PRACTICE* 8, 24–25 (Valerie A. Earle ed., 1968)).

concurrent jurisdiction.”²¹³ While dual oversight has benefits, some argue that in particular areas, most specifically the duty of care, regulation should be left to the states, which are better equipped to understand the needs of the organizations within their jurisdiction.²¹⁴

VIII. CONCLUSION

IRC section 501(c)(3), the statutory section under which organizations are granted tax-exempt status,²¹⁵ states that an organization must be organized and operated for charitable purposes,²¹⁶ that it cannot allow any private inurement,²¹⁷ and that it cannot engage in political activity.²¹⁸ As discussed earlier, the operational test requires that a charitable nonprofit operate on a daily basis in keeping with its charitable mission. To do so, its board must oversee the operation of the organization to ensure no violations occur. These violations, as seen previously, can include operating for the private benefit of individuals or groups, through self-dealing, or operating in a commercial manner or in a manner not consistent with the organization’s mission. The board must also ensure compliance with the private inurement and private benefit doctrines²¹⁹ so that the organization does not violate the requirement and maintenance standards of section 501(c)(3). The nonprofit is incorporated under state law and state statutes, which, along with the organization’s bylaws, set out the procedures for functioning as a board and operating as a nonprofit. In the application for nonprofit status, most states include a form that mirrors section 501(c)(3) requirements, allowing the nonprofit to seek federal exemption status, giving way to federal oversight, as well.

Because of this unique incorporation process, and the Congressional history briefly outlined in Part II of this Article, a great

²¹³ *Id.* (citing Ernest Young, *Dual Federalism, Concurrent Jurisdiction, and the Foreign Affairs Exception*, 69 GEO. WASH. L. REV. 139, 143–45 (2001)).

²¹⁴ Mayer, *supra* note 8.

²¹⁵ 26 U.S.C. § 501(c)(3) (2018) (exempting “[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . , or for the prevention of cruelty to children or animals. . . .”).

²¹⁶ *Id.*

²¹⁷ *See id.*

²¹⁸ *Id.*

²¹⁹ CAFARDI & CHERRY, *supra* note 2, at 104–15 (discussing private inurement); CAFARDI & CHERRY, UNDERSTANDING, *supra* note 18, at 73 (discussing private benefit test).

deal of dual oversight has occurred over the years. What has been missing is coordination of these state and federal efforts, though in recent years greater effort has been made to encourage and facilitate information-sharing efforts. Moreover, while the IRS is asking more governance questions on Forms 1023 and 990, it cannot directly enforce any failure to comply unless there has been a violation of the law, so that coordination is not only efficient but necessary. Given these facts, it remains that a lack of resources still exists in this area (federal and state), and scandals, such as those discussed herein, are occurring every day in this sector. In the past, it was suggested that an Independent, non-governmental committee be formed to advise and regulate this sector, but to no avail.

One solution may be to push for more clarity from Congress and seek more notice and comment from the IRS when it is making decisions that impact the sector, which may allow for better jurisdictional coordination. The IRS Commissioner and attorneys general (both political appointments) should be given clearer mandates regarding their roles so that decisions in this area can be made clearly and in accordance with statutory language. Allowing that this is largely a resource issue, there does not seem to be another valid way to regulate charitable nonprofit organizations but to involve both in this regulation.